

Rethinking Your 401(k) Plan

The recession and market meltdown that has whacked all types of investments has added fuel to the debate about the need to fix the current 401(k) system. There are those calling for scrapping existing plans entirely and those who say the system is fine as is. Some experts think the answer lies in annuities.

Really? Annuities, the complex products people don't quite get? Even before the recent financial turmoil, it was clear there would be a separate crisis involving retirees. People relying on their 401(k)s are facing the quandary of how to manage their lump sums so that they have enough to meet their living costs for as long as they live, says Alicia Munnell, director of the Center for Retirement Research at Boston College. One way to avoid that problem: annuities. "I have no compunction about putting annuities as a default in 401(k)s," Munnell says, adding that she realizes it may not be as good for everyone as the recent decision to automatically enroll people into 401(k)s. "But it's still the better way to go." The basic idea: Turn 401(k) balances into a steady stream of income – much like Social Security.

Despite a newfound push to bolster retirement savings, annuities are laden with issues that even the proponents quickly acknowledge. For starters, annuities are costly for the average retiree. Plus, they require the psychologically difficult act of handing over a large lump sum to an insurer for good in return for a drip-like monthly payment for life. The current financial crisis has only heightened fears about annuities as confidence in insurers ~~lags~~ (AIG ¹) that back them wavers and the models used to ensure payouts raise questions. "Right now there is not a lot of experience of how these annuities are going to turn out and even if the company is going to still be there," says Craig Copeland, senior research associate at Employee Benefit Research Institute.

Even the most vocal proponents agree with some of the concerns. The possible mistakes in setting the right default for annuity products can cause more havoc than picking the wrong level of savings for automatic enrollment, says William Gale, director of the Retirement Security Project and vice president at the Brookings Institute. To get over these not-so-small hurdles, Gale proposes a three-pronged strategy. Here's a more in-depth look at his idea:

Test Driving an Annuity

Implement a possible two-year annuity test-run. This time period would get retirees familiar with getting a small but steady stream of money each month — and, perhaps, it would be long enough to get them to stay put after the test is over. The larger the participation, the more costs could come down. One reason for the steep fees on annuities is adverse selection, economist-speak for the fact that the people signing up for annuities are often those likely to live long lives — and cost the insurer much more than those with shorter life spans. But if retirees were automatically enrolled into the annuity test-run, it would draw in a larger swath of the population with different life spans, reducing the cost of annuities. People could opt out of the test, of course, but the push toward automatic enrollment into 401(k)s has shown that most people stick with the default option.

Much Like Dollar-Cost-Averaging

Right now, a retiree could have done everything right — from saving more than an adequate amount to picking the right investment options — but could still see a paltry payout from an annuity if interest rates are near lows. To offset that risk, Gale proposes continual contributions to an annuity that accumulates over, say 30, years — balancing out high and low interest rates over the years. One way to fund the annuity: Directing an employer's match into the annuity rather than company stock or other investments.

Government Backstop

Not surprisingly, these proposals will need some government help. To get Americans to embrace annuities in their 401(k)s, they're going to need some guarantees — namely insurance for the annuity providers to make sure the person holding their nest egg isn't going to go belly-up. Gale recommends something akin to the FDIC's backing of savings deposits and says the current state-level regulation of insurers would have to be changed to allow for some federal system.

¹<http://www.smartmoney.com/quote/AIG/>

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